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In the Supreme Court of the United States

OCTOBER TERM, 1935

No. 174

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, petitioner

v.

MINNESOTA TEA COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 83–90) is reported in 28 B. T. A. 591. The majority and dissenting opinions in the Circuit Court of Appeals are reported in 76 F. (2d) 797. (R. 112–123.)

JURISDICTION

The judgment of the Circuit Court of Appeals was entered March 25, 1935. (R. 124.) The peti-

tion for a writ of certiorari was filed June 25, 1935, and granted October 14, 1935. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Whether the definition of the term "reorganization" contained in clause (A) of Section 112 (i) (1) of the Revenue Act of 1928 should be limited to transactions which partake of the nature of mergers or consolidations.

2. Whether the statute may be availed of where it appears that preparatory to the transfer in question the taxpayer divested itself of certain assets and that only as thus reduced was there a transfer of "substantially all" of its property.

STATUTES AND REGULATIONS INVOLVED

The pertinent statutes and regulations involved will be found in Appendix A, *infra*, pp. 36–39.

STATEMENT

The facts, as stipulated before the Board of Tax Appeals (R. 10–12) are substantially as follows:

The respondent is a Minnesota corporation, with principal office at 2023 West Superior Street, Duluth, Minnesota, and was, until the transfer of its assets hereinafter mentioned, engaged in the business of selling teas, coffees, and groceries at retail. (R. 10.)

On July 14, 1928, the respondent formed, or caused to be formed, the Peterson Investment Company, a corporation, and transferred thereto certain of its assets in exchange for the entire capital stock of Peterson Investment Company. The assets so transferred to the newly formed corporation consisted of real estate and buildings, investments, and other miscellaneous assets. Immediately upon receipt of the stock of Peterson Investment Company it was distributed by respondent *pro rata* among its stockholders. On August 23, 1928, respondent transferred all of its remaining assets to Grand Union Company, another corporation, and received in exchange therefor Voting Trust Certificates for 18,000 shares of common stock of said Grand Union Company, plus $426,842.52 in cash. (R. 11, 16, 84.)

The transfer effected was accomplished in accordance with the following plan (R. 11; Ex. B, R. 15–20):

On July 2, 1928, the respondent's officers granted an irrevocable option to O. B. Westphal (who was acting as agent for Grand Union Company), to acquire the respondent's inventories, bills, notes, and accounts receivable, furnishings and equipment, and good will in exchange for Voting Trust Certificates for 18,000 shares of common stock of the Grand Union Company, plus $400,000 in cash, plus or minus the difference between the value of the assets at the date of conveyance and the value

on December 31, 1927. Under this option, if exercised, the respondent obligated itself to sell, and the Grand Union Company to buy the above-described assets. (R. 11.) On July 6, 1928, the option of July 2, 1928, was accepted. (R. 11.) On July 24, 1928, an agreement, supplemental to the option of July 2, 1928, was accomplished, fixing August 25, 1928, as the delivery date and providing, for convenience, that the valuation date of the assets should be August 4, 1928, instead of the delivery date. (R. 11; Ex. D, R. 24–25.)

On August 22, 1928, the stockholders of the respondent adopted a resolution (1) ratifying the action of the respondent's officers in signing the option of July 2, 1928, and the agreement of July 24, 1928; (2) authorizing the sale and transfer of all its assets upon the terms stipulated in the option and modifying agreement, or upon such other terms as the directors might deem advisable; and (3) providing that the corporate stock to be received in exchange should be retained by the respondent and that the cash to be received in exchange should be immediately distributed to the respondent's stockholders in proportion to their respective stockholdings. (R. 11; Ex. A, R. 12–15.)

On August 23, 1928, the stockholders of the respondent adopted a resolution authorizing the officers to execute and deliver a bill of sale and instrument transferring the property to the Grand Union Company. (R. 11–12; Ex. E, R. 25–26.)

Upon receipt of the cash and stock, the respondent immediately paid the entire sum of $426,842.52 to its stockholders in proportion to their stockholdings, and the stockholders agreed to pay the corporate debts. (R. 11–12.) The amount of the liabilities of the respondent on August 23, 1928, which was assumed and discharged by its stockholders, pursuant to the resolution, was $106,471.73. (R. 12.)

Under the option, resolution, bill of sale, and all the agreements whereby the transfer of respondent's assets to the Grand Union Company for cash and stock of the latter was accomplished, the transaction is described as one of purchase and sale; the respondent being described as the "seller", and the Grand Union Company, or its agent, "the buyer." (R. 12, 15, 20, 24, 28.)

Petitioner, in determining the proposed deficiency herein, added to respondent's taxable income for 1928 an amount of $106,471.73, representing an alleged profit realized upon the above transfer of assets to the Grand Union Company. (R. 12.) If the said amount of $106,471.73 so added by the petitioner to respondent's taxable income be excluded therefrom, and if the transaction above described constituted a statutory reorganization, respondent sustained a net loss for the year. (R. 12.)

The matter was brought before the Board of Tax Appeals for review upon the issue of whether or

not the respondent realized a taxable gain of $106,471.73 as a result of the transactions above set forth (R. 3–4), both petitioner and respondent proceeding on the assumption that a statutory reorganization had been effected. (R. 97.) The Board of Tax Appeals, of its own motion, raised the question as to whether such statutory reorganization had been effected,[1] and in its decision held that there was no reorganization, and that the respondent realized a gain measured by the difference between $254,646.62, the cost of its property, and $966,842.52 (being the sum of $426,842.52 cash and $540,000, the value of 18,000 shares of Grand Union Company), and held that this gain of $712,195.90 was taxable. (R. 83–88.) The Circuit Court of Appeals reversed the Board, holding that the transaction was a reorganization. (R. 112–119.)

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In failing to limit the definition of "reorganization" contained in clause (A) of Section 112 (i) (1) of the Revenue Act of 1928 to transactions

[1] In this connection, the Board of Tax Appeals gave both counsel opportunity to brief fully the question of whether or not there had been a statutory reorganization. Counsel for the respondent accordingly submitted a brief thereon prior to the promulgation of the Board's opinion. (R. 97, 103–104.) This statement is due the Board of Tax Appeals in order that it may appear that its decision was not reached without affording the parties a full opportunity to be heard.

which partake of the nature of a merger or consolidation.

2. In giving effect to an administrative construction which is inconsistent with the statute.

3. In failing to hold that the transaction here involved was not a reorganization within the meaning of the Revenue Acts.

4. In failing to take into account the fact that the respondent had made an anticipatory transfer of the portion of its assets not desired by the Grand Union Company, and hence that the transfer to the Grand Union Company was not a substantial compliance with the statutory requirement that "substantially all" of the property be transferred.

5. In reversing the decision of the Board of Tax Appeals.

SUMMARY OF ARGUMENT

The statute contains two definitions of a reorganization accomplished by the transfer of assets from one corporation to another. One (clause (B)) requires that the transferor shall be in control of the transferee after the transfer. The other (clause (A)) has no such condition, but it is a part of a parenthetical clause added to "merger or consolidation." These clauses have separate legislative histories and are obviously intended to be mutually exclusive. These circumstances admit of no doubt that the clause (A) definition must be restricted in order to avoid rendering nugatory the condition of the clause (B) definition. This Court has already

indicated that the appropriate restriction is to confine the clause (A) definition to transactions which partake of the nature of mergers or consolidations.

The transaction here involved fails to conform substantially to certain basic elements found in mergers and consolidations. It resulted in a substantial change in the relation of the taxpayer to its former assets, and neither the taxpayer nor its stockholders acquired a voice in the new management. A large proportion of cash entered into the transaction. The transaction has many attributes of a sale and we submit that it did not partake of the nature of a merger or consolidation.

Prior to the transfer of assets to the Grand Union Company the taxpayer divested itself of certain assets which the Grand Union Company was not to acquire. Only as thus reduced is there any basis for the contention that substantially all of the assets were transferred. We submit that such an anticipatory transfer should be treated as a step in a single transaction and that the purpose of Congress to require a transfer of "substantially all" the assets may not thus be defeated.

ARGUMENT

I

THE STATUTE CONTAINS TWO OVERLAPPING DEFINITIONS OF REORGANIZATION. THEY CAN BE RECONCILED ONLY BY RESTRICTING THE CLAUSE (A) DEFINITION TO TRANSACTIONS WHICH RESULT IN MERGERS OR CONSOLIDATIONS OR PARTAKE OF THEIR NATURE.

As a general rule gains upon exchanges of property are taxable. Section 112 (a) of the Revenue Act of 1928 (Appendix A, *infra*, p. 36) in terms so declares, "except as hereinafter provided in this section." The transaction here involved was a disposition of property which admittedly produced a profit. There is no controversy with respect to the amount of the profit, the sole question being whether the respondent is freed from taxation on it by the exceptions contained in other provisions of Section 112. It is, of course, well settled that one claiming an exemption from tax must bring himself squarely within the provisions of the statute under which he claims such exemption. The rule is equally applicable to a taxpayer who claims the benefit of exceptional treatment. *Bowers* v. *Lawyers Mortgage Co.*, 285 U. S. 182, 187.

The exemption on which the taxpayer relies is contained in Section 112 (b) (4) as modified by Section 112 (d) (1). Section 112 (b) (4) provides that—

> No gain or loss shall be recognized if a corporation a party to a reorganization ex-

> changes property, in pursuance of the plan of reorganization, *solely for stock or securities in another corporation a party to the reorganization.* (Italics supplied.)

This provision is qualified by Section 112 (d), which provides that money or property other than stock or securities may enter into the transaction, but, if not distributed by the corporation pursuant to the plan of reorganization, shall be taxable to the extent that gain is involved.

The word "reorganization" as used in the section is defined in Section 112 (i), which, so far as applicable here, is as follows:

> (1) The term "reorganization" means (A) a merger or consolidation (including the acquisition by one corporation of • • • substantially all the properties of another corporation), or (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transferor or its stockholders or both are in control of the corporation to which the assets are transferred • • •.

"Control" is defined in Section 112 (j) as the ownership of at least 80% of all classes of stock, including at least 80% of the voting stock.

Respondent's case depends upon whether the transaction satisfies one of these definitions. It is clearly not within the clause (B) definition because of the absence of the requisite control. Respondent says that Grand Union acquired "substantially all

the properties of another corporation", and hence that clause (A) of the statutory definition literally applies. However, the quoted words do not stand alone in the definition. They constitute a parenthetical clause modifying the words "merger or consolidation", and it is necessary to consider the definition as a whole.

The rule is thus stated in *Helvering* v. *Morgan's, Inc.*, 293 U. S. 121, 126:

> But the true meaning of a single section of a statute in a setting as complex as that of the revenue acts, however precise its language, cannot be ascertained if it be considered apart from related sections, or if the mind be isolated from the history of the income-tax legislation of which it is an integral part.

The underlying purpose of the statute was to relieve from the tax only those transactions which effect purely formal adjustments in corporate structures. *Cortland Specialty Co.* v. *Commissioner*, 60 F. (2d) 937 (C. C. A. 2nd), certiorari denied, 288 U. S. 599; *West Texas Refining & D. Co.* v. *Commissioner*, 68 F. (2d) 77 (C. C. A. 10th). In the Revenue Act of 1918 (c. 18, 40 Stat. 1057) the first attempt was made to deal with this situation and relieve purely paper profits from taxation. This legislation proved unsatisfactory, and in presenting the reorganization provisions of the Revenue Act of 1921 (c. 136, 42 Stat. 227), the report

of the Senate Finance Committee stated (S. Rep. No. 275, 67th Cong., 1st Sess., p. 11):

> Section 202 (subdivision c) provides new rules for those exchanges or "trades" in which, although a technical "gain" may be realized under the present law, the taxpayer actually realizes no cash profit.

Thus Congress never intended that the reorganization provisions should be extended to sales or other transactions which substantially change the taxpayer's situation. This is now well settled. *Cortland Specialty Co.* v. *Commissioner*, 60 F. (2d) 937 (C. C. A. 2nd), certiorari denied, 288 U. S. 599; *Pinellas Ice Co.* v. *Commissioner*, 287 U. S. 462; *Prairie Oil & Gas Co.* v. *Motter*, 66 F. (2d) 309 (C. C. A. 10th); *Lonsdale* v. *Commissioner*, 32 F. (2d) 537 (C. C. A. 8th), certiorari denied, 280 U. S. 575. Accordingly, not every acquisition of substantially all the properties of another corporation is within the purview of this statute.

As introduced in the House of Representatives the Revenue Act of 1921 defined the term "reorganization" simply as a merger or consolidation. In the Senate there was added to this definition the case where one corporation acquires at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation. H. Conference Rep. No. 486, 67th Cong., 1st Sess., pp. 17–18. This was the origin of clause (A) of the definition in

Section 112 (i), Revenue Act of 1928. The addition made by the Senate was thrown into parentheses, thus showing that while Congress was extending the definition of "reorganization" so as to include transactions which were not strictly mergers or consolidations, it was nevertheless intended to exclude transactions which were wholly foreign to mergers or consolidations.

This parenthetical definition was considered in *Pinellas Ice Co.* v. *Commissioner, supra,* and this Court said (pp. 469–470):

> The words within the parenthesis may not be disregarded. They expand the meaning of "merger" or "consolidation" so as to include some things which partake of the nature of a merger or consolidation but are beyond the ordinary and commonly accepted meaning of those words—so as to embrace circumstances difficult to delimit but which in strictness cannot be designated as either merger or consolidation.

We think that this statement marks the limit of the expanded meaning and that the parenthetical language of clause (A) is applicable only where the transaction is closely related to a merger or consolidation. *C. H. Mead Coal Co.* v. *Commissioner,* 72 F. (2d) 22 (C. C. A. 4th); *G. & K. Mfg. Co.* v. *Commissioner,* 76 F. (2d) 454 (C. C. A. 4th), now pending in this Court, No. 187, present term; *John A. Nelson Co.* v. *Commissioner,* 75 F. (2d) 696

(C. C. A. 7th), now pending before this Court, No. 61, present term.

This view finds support in the fact that the next Revenue Act added a definition which covered a transfer of corporate assets by a transaction not partaking of the nature of a merger or consolidation. When Congress reenacted the reorganization provisions in the Revenue Act of 1924 (c. 234, 43 Stat. 253), there was included the additional definition (Section 203 (h) (1) (B).), which appears as clause (B) of Section 112 (i), Revenue Act of 1928 (*infra*, p. 36), viz: a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or its stockholders, or both, are in control of the corporation to which the assets are transferred. When this language was inserted in the Revenue Act of 1924 its purpose was thus explained by the House Committee on Ways and Means (H. Rep. No. 179, 68th Cong., 1st Sess., p. 16):

> Subdivision (h) (1) contains a definition of reorganization which corresponds to the definition contained in section 202 (c) (2) of the existing law. The only change in the definition is to include within its terms the case of a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders, or both, are in control of the corporation to which the assets

> are transferred. This is a common type of reorganization, and clearly should be included within the reorganization provisions of the statute.

See also S. Rep. No. 398, 68th Cong., 1st Sess., p. 17.

Thus it appears that Congress intended clause (B) to include transactions which were not already provided for by clause (A), and it is also apparent from the legislative history of clause (B) that the two definitions were intended to be mutually exclusive. To achieve that result it is necessary to limit the scope of clause (A). Hence we submit that, as indicated by this Court in the *Pinellas* case, *supra*, it is applicable only to those transactions which approach true mergers or consolidations. This construction leaves to clause (B) the field of transfers of corporate assets which are accomplished by transactions having no resemblance to mergers or consolidations. Clauses (A) and (B) are in this way brought into complete harmony, and the true significance of the parenthetical modification of "merger or consolidation" is given effect. *Minnesota Tea Co.* v. *Commissioner*, 28 B. T. A. 591. (R. 86.)

Moreover, unless this construction be adopted, there is presented the anomalous situation of having two applicable definitions with different requirements, for both clause (A) and clause (B) include transfers of assets from one corporation to another, and clause (B) contains a requirement for

control by the transferor or its stockholders which is omitted in clause (A). It is only by limiting clause (A) to mergers, consolidations, or transactions partaking of their nature that this result can be avoided.

This added requirement of control in clause (B) must be accorded its proper significance. It is definitely established that in order for a transferor to receive the benefit of the statute it must acquire an intimate interest in the affairs of the transferee. *Pinellas Ice Co.* v. *Commissioner, supra.* If the transaction approaches a merger or consolidation, and clause (A) of Section 112 (i) applies, this continuity of interest exists. Hence no minimum stock interest is expressly required in a clause (A) reorganization. Where, however, the transaction does not approach a merger or consolidation, but instead assumes the character of a substantial rather than a formal change, Congress was unwilling to treat it as a reorganization unless, as provided by clause (B), "the transferor or its stockholders or both are in control of the corporation to which the assets are transferred."

Thus Congress has seen fit to make a distinction between the two situations where the transferee takes over the operation of the properties of another corporation (1) by a merger, consolidation, or something akin thereto, or (2) by a transaction unrelated to a merger or consolidation. When

viewed in the light of the general purpose of the statute not to recognize gains or losses arising from transactions involving mere formal changes in the business structure, it is submitted that this distinction is a reasonable one. Certainly it cannot be doubted that where a corporation has divested itself of substantially all of its assets by a sale, its relationship to those assets has undergone a substantial change and for tax purposes the transaction should be regarded as closed. Accordingly, Congress was unwilling to recognize transfers of assets as reorganizations unless they were either (1) accomplished in connection with a merger or consolidation, as expanded by clause (A), or (2) accompanied by an 80% proprietary control of the transferee, and thus came within clause (B).

In view of what has been said above, we regard it as settled that the transactions under clause (A) must partake of the nature of a merger or consolidation. Therefore, it becomes important to inquire what are the elements of a strict merger or consolidation. They were defined in *Cortland Specialty Co.* v. *Commissioner, supra* (p. 939) as follows:

> A merger ordinarily is an absorption by one corporation of the properties and franchises of another whose stock it has acquired. The merged corporation ceases to exist, and the merging corporation alone survives. A consolidation involves a disso-

lution of the companies consolidating and a transfer of corporate assets and franchises to a new company.

We believe it is true that mergers and consolidations embrace the following elements: (1) An agreement between two or more corporations to combine their enterprises. (2) The continued participation of the stockholders of the combining corporations. (3) The assumption by the surviving corporation of the liabilities of the old company (both *ex contractu* and *ex delicto*). (4) The dissolution of some or all of the old companies.

In addition, there are various formal requisites, such as a formal agreement specifying the plan in detail; the specific ratification by a required proportion of the stockholders; recording with a specific State officer and the payment of a fee, etc. It is clear enough that Congress was not concerned with such details as these.

We think that the obvious requirements of the statute follow closely the substantial elements of mergers and consolidations stated above. The statute requires that the transaction be an exchange as distinguished from a sale. The general rule in Section 112 (a) (Appendix A, *infra*, p. 36) applies to a "sale or exchange". But the exception upon which respondent relies (Section 112 (b) (4), Appendix A, *infra*, p. 36) is limited in its application to exchanges.

A plan of reorganization is required and this Court has held it to be essential. *Gregory* v. *Hel-*

vering, 293 U. S. 465. The plan must be a corporate plan between two or more corporations, since Section 112 (b) (4) requires that "a corporation a party to a reorganization" receive for its property "stock or securities in another corporation a party to the reorganization."

A corporation which transfers its assets in pursuance of a plan of reorganization must preserve its interest in the assets transferred. *Pinellas Ice Co.* v. *Commissioner, supra.* Since Section 112 (b) (4) postpones the tax only upon "stock or securities in another corporation a party to the reorganization", it seems logical that the continuity of interest must be evidenced by such stock or securities. So far as the clause (A) transfers are concerned the statute specifies no definite measure of continuity. But it seems clear that it must be the substantial equivalent of the property transferred. This seems to follow from the fundamental purpose of the statute to postpone the ta nly in cases where there is a formal rather th a substantial change. This view is further supported by the fact that the transferee of the corporate assets is required to assume the basis of the transferor for the purpose of depreciation, depletion, and gain or loss upon subsequent dispositions of the property. See Section 113, Revenue Act of 1928. The statutory plan is to defer taxation upon condition that the property exchanged shall continue to be dealt with, for tax purposes, upon the same basis as that

used by the transferor. Thus the transferee is not permitted to "step up" the basis to the value at the time of acquisition or the amount of the consideration paid to the transferor. This plan is perfectly consistent with the application of the reorganization provisions solely to formal changes where the same proprietors are employing the same assets in the same business. Since the transferor corporations and their stockholders are the ones to benefit by the reorganization provisions, it is reasonable to believe that Congress expected that the compensating burden of using the old basis would be borne by them through their proprietary interest in the transferee. It is also significant that Section 112 (b) (4) limits the tax-free property *solely* to stock or securities and that cash or property other than stock or securities is permitted to be received tax free only to the extent that it does not represent gain (Section 112 (d), Appendix A, *infra*, p. 36). Such "other property or money" was referred to in the legislative history[1] as "boot", and it seems clear that Congress expected it to be comparatively insignificant in amount. Accordingly, we submit that the proportion between "stock or securities", on the one hand, and "other property or money", on the other hand, should be subjected to close scrutiny in determining the applicability of the statute.

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[1] H. Rep. No. 179, 68th Cong., 1st Sess., p. 14; S. Rept. No. 398, 68th Cong., 1st Sess., p. 15.

Under earlier acts it was the rule that stockholders realized income upon an exchange of securities even where they represented a different interest in the same business enterprise (*Marr* v. *United States*, 268 U. S. 536, 540), and it seems clear that the reorganization provisions were primarily designed to postpone the tax upon such paper profits. *C. H. Mead Coal Co.* v. *Commissioner, supra* (p. 27). We submit that the Court should be slow to extend the application of the statute to other fields.

With respect to the assumption of liabilities, the general rule is that where one corporation sells or otherwise transfers all of its assets to another corporation, the latter is not liable for the debts and liabilities of the transferor. But this rule is not applicable where the transaction amounts to a merger or consolidation or where the purchasing corporation is merely a continuation of the selling corporation. *West Texas Refining & D. Co.* v. *Commissioner*, 68 F. (2d) 77; Jones on Insolvent and Failing Corporations, p. 293; *Consol. Gas Co.* v. *Balto. County*, 98 Md. 689; *Mayor and C. C. of Baltimore* v. *Balt. and Ohio R. R. Co.*, 6 Gill (Md.) 288. Since the statute as interpreted by this Court in the *Pinellas* case, *supra*, makes a sharp distinction between sales and reorganizations, and since the statute deals with a combination in which the old proprietors have a continuing interest, it would be reasonable to expect to find the surviving corporation recognizing its liability for all claims attach-

ing to those assets or growing out of their use under the old corporate structure.

With respect to dissolution, it would appear that a combination of enterprises which preserves the requisite continuity of interest would ordinarily result in the dissolution of the old corporation. In this view it would be necessary to define "substantially all the properties", where this language appears in clause (A), as all except the property necessary to the winding up of the old corporation's affairs. We do not contend that the old corporations should immediately dissolve in order that the transaction should partake of the nature of a merger or consolidation. In strict mergers or consolidations they are not always permitted to dissolve immediately (see Connecticut statute referred to in *Arrow-Hart & H. Co.* v. *Comm'n*, 291 U. S. 587), but if there is required a plan of reorganization whereby the old business is to be conducted under a changed corporate structure (*Cortland Specialty Co.* v. *Commissioner, supra*, p. 940), it seems consistent with the scheme of the statute to require that the plan should include the ultimate dissolution of the constituent corporations. *Fordyce* v. *Helvering*, 76 F. (2d) 431 (App. D. C.). The statute does not deal with a mere association of co-existing corporations, but with a continuing business in a new form. If Congress intended to permit the old corporations to remain alive and hold indefinitely the stock or securities evidencing

a continuation of interest, it has encouraged, as tax-free, transactions which would result *pro tanto* in eliminating the tax upon corporate dividends to be subsequently paid upon such stock. This result would inevitably follow, because corporations pay no tax upon dividends received from other domestic corporations. Section 23 (p), Revenue Act of 1928. There is no evidence anywhere that Congress intended to be so generous. The legislative history evidences a purpose merely to *defer* the taxation of the gains involved in a reorganization, and it is not to be supposed that in achieving that result Congress was willing to *permanently exempt* from taxation large amounts of corporate dividends.

In view of the above, we think there is a sound basis for the conclusion that clause (A) reorganizations should substantially satisfy the basic elements of mergers and consolidations, but that the formal requisites may be dispensed with.

II

THE TRANSFER TO THE GRAND UNION COMPANY DID NOT SUFFICIENTLY PARTAKE OF THE NATURE OF A MERGER OR CONSOLIDATION TO BE TREATED AS A REORGANIZATION

The transaction here under examination fails in several particulars to satisfy the requirements discussed above: (1) There was no plan of reorganization. (2) Respondent received no stock and the voting-trust certificates gave it no voice in the management. (3) The proportion of cash to stock

interest was so large that respondent's proprietary interest after the transfer was not substantially in proportion to its contribution to the combined business. Therefore, the exchange resulted in a change of substance rather than a change of form. (4) Respondent's liabilities were not assumed by the Grand Union Company. (5) Respondent's stockholders did not become stockholders of the Grand Union Company, nor was it a part of the plan that they should. Respondent itself held the Grand Union voting trust certificates. (6) Respondent did not dissolve and the plan did not contemplate that it should, nor was there any change whatsoever in its corporate structure.

We shall briefly discuss each of the points enumerated above.

(1) The record is bare of any evidence that the respondent and the Grand Union Company desired to effect a reorganization. Instead of commencing with a plan of reorganization, the negotiations in this case began with an option to purchase. On July 2, 1928, respondent's president and secretary (two of its three stockholders) gave an irrevocable option to O. B. Westphal (R. 15), who was acting on behalf of the Grand Union Company (R. 11). It was an option to purchase, was couched in terms of purchase and sale, and respondent agreed to comply with any applicable Bulk Sales Laws. (R. 20.) The option was accepted by Westphal on July 6, 1928. (R. 11.) On July 24, 1928, a supplemental agreement was entered into (R. 24) "for

the Purchase of Minnesota Tea Company Property." These agreements were ratified by respondent's stockholders at a special meeting on August 22, 1928 (R. 12) as a sale of the company's assets, and the Board of Directors was authorized to accomplish the transaction by bill of sale (R. 14). Also upon August 22, 1928, respondent's Board of Directors met (R. 20), ratified the agreements of July 2, 1928, and July 24, 1928, resolved to sell respondent's assets pursuant to the agreements, and authorized the officers to execute the bill of sale (R. 22). At a meeting of the stockholders on August 23, 1928 (R. 25) the proposed bill of sale was presented and approved. Pursuant to the authority given, respondent's officers transferred the specified assets to the Grand Union Company by bill of sale. (R. 28.) Here, as in the *Pinellas* case, *supra,* the negotiations and the transfer itself were in terms of purchase and sale. There was no purpose to reorganize and the transaction was not carried out pursuant to a plan of reorganization.

In contrast with the minutes authorizing the sale to the Grand Union Company (R. 13) are the minutes of June 18, 1928, authorizing a corporate reorganization by the formation of the Peterson Investment Company and the transfer to it of certain assets in exchange for all of the stock of the Peterson Investment Company (R. 26–27). These resolutions differ radically from those adopted with reference to the Grand Union transaction and indicate clearly that respondent regarded the latter

transaction as a sale and the Peterson transaction as a reorganization.

(2) Although it is stipulated (R. 11) that respondent received 18,000 shares of common stock of the Grand Union Company, this statement is not strictly accurate. The option agreement (R. 16) shows that respondent agreed to receive voting-trust certificates for 18,000 shares of common stock of the Grand Union Company, and the Board of Tax Appeals found that it did receive voting-trust certificates (R. 84). Voting-trust certificates, of course, gave respondent no voice in the management of the business. While the certificates gave respondent a proprietary interest, it was an interest radically different from that theretofore held. Respondent parted with its assets and retained only a right to share in the earnings which they might produce under the new management, but it had no longer even a voice in the management. Under the agreement, respondent's three stockholders became employees of the Grand Union Company. (R. 19.) Accordingly, we submit that the transaction with the Grand Union Company caused a substantial change in the status of both respondent and its stockholders, and that this transaction does not exhibit the change of form rather than of substance to which Congress intended to limit the special consideration provided for by the reorganization provisions.

(3) The 18,000 shares of Grand Union stock represented by the voting trust certificates were val-

ued at $540,000. (R. 88.) In addition respondent received $426,842.52 in cash. (R. 88.) For the reasons set forth above, we submit that such a large proportion of cash is inconsistent with a corporate reorganization which involves merely a formal change. In effect respondent disposed of nearly 50% of its proprietary interest, which is inconsistent with a statute dealing with exchanges solely for stock or securities and permitting cash and other property to be received only as "boot".

(4) The Grand Union Company did not assume any of respondent's liabilities, except contracts for the purchase of goods, and, in addition, contracts for chattels, machinery and equipment entered into with the consent of the Grand Union Company during the option period. (R. 16.) Respondent's stockholders agreed to pay all the corporate debts, whether due or payable, and whether certain or contingent. (R. 14, 23.) As pointed out above, it is one of the indicia of a reorganization, as distinguished from a sale, that the surviving corporation assume the liabilities of the old company.

(5) Respondent's stockholders did not become stockholders of the Grand Union Company. It was a part of the plan that the Minnesota Tea Company continue to own and hold the common stock of the Grand Union Company represented by the voting trust certificates. (R. 14.) As pointed out above, this has the effect of making the dividends nontaxable. The result is that after this transaction re-

spondent reported neither the profits earned by its former assets nor the dividends declared by the new management. The Minnesota Tea Company retained all its corporate powers, made no change in its corporate structure, and the status of its stockholders changed from direct managers of a local tea business to employees of the Grand Union Company. We submit that these changes are substantial and not formal.

(6) The Minnesota Tea Company remained in existence. Before the transaction its business was the selling of teas, coffees, and groceries at retail. (R. 10.) Its agreement with the Grand Union Company specified that it would not thereafter engage in the Wagon Route tea and coffee business in any part of the United States. (R. 19.) Apparently respondent was free to engage in the grocery business and in any business involving the marketing of tea and coffee by other means than Wagon Routes. After the transfer there were two coexisting corporations, with the Minnesota Tea Company holding a 7½% interest in the Grand Union Company. (R. 84.) It is clear, we think, that by the transfer respondent completely changed its former status with respect to the assets transferred to the Grand Union Company and did not continue the conduct of the same business with the same assets under a different corporate form. It was free to compete with the Grand Union Company if such a course had proven advisable. Its corporate exist-

ence was not continued for any temporary purpose connected with the winding up of the business, and no change occurred in its corporate structure.

For these reasons, we think that the transaction was not a reorganization.

The decision of the Circuit Court of Appeals is predicated chiefly upon the wording of the statute (R. 114), the administrative construction (R. 115), and the intent of Congress (R. 116). Insofar as the court relied upon the literal language of the statute, its decision is clearly in conflict with those of this Court in *Pinellas Ice Co.* v. *Commissioner, supra;* and *Gregory* v. *Helvering, supra.*

Nor has the administrative practice, as represented by the Treasury Regulations,[3] been sufficiently specific to support the decision below. The regulations consist largely of a paraphrase of the statutory provisions, but they emphasize that the statute is dealing with corporate reorganizations which result only in a change of form which does not substantially affect the property interests of either the shareholders or the corporations. The examples given in the regulations should be read in the light of this general principle and the cautionary statement that "the statute does not allow the use of reorganizations to avoid the tax". The rule that the contemporaneous interpretation of the statute by the administrative officers charged with

[3] Treasury Regulations 65 and 69, Articles 1574 and 1577; Treasury Regulations 74, Articles 574 and 577.

its enforcement will be given great weight, is not without exception and this Court has power to disregard it. *Fox* v. *Standard Oil Co.*, 294 U. S. 87. So far as the decisions of the Treasury Department applying the regulations are concerned, this Court has declared that they have no more force than the reasons given to sustain them. *Burnet* v. *Chicago Portrait Co.*, 285 U. S. 1.

The administrative practice failed to give proper effect to the introduction in the Revenue Act of 1924 of the definition in clause (B). Since the 1924 Act clearly required that the transferor retain an 80% control of the transferee in a transfer involving "all or a part" of its assets, it is evident that the clause (A) definition could not be literally applied without rendering that requirement nugatory. Insofar as the administrative practice failed to heed the necessity of correlating the clause (A) definition with the clause (B) definition,* we think it should be disregarded.

The provisions of the law are quite complicated and have proven to be difficult to interpret consistently when applied to actual cases as they arise, although the Treasury has consistently treated the parenthetical clause as enlarging the scope of the definition so as to include transactions which technically are not mergers or consolidations. The Statement of the Acting Secretary of the Treasury regarding the Preliminary Report of a Subcom-

* G. C. M. 1753, VI-1 Cumulative Bulletin 138.

mittee of the Committee on Ways and Means (1933) (Appendix B, *infra*, p. 49) shows some of the difficulties. The Preliminary Report of the Subcommittee of the Committee on Ways and Means, 73d Congress, 2nd Session, to which the Acting Secretary of the Treasury's statement referred, recommended the abolition of the reorganization provisions. However, the provisions were reenacted in the Revenue Act of 1934 with important changes designed to close loopholes in the prior law. Section 112, Revenue Act of 1934, c. 277, 48 Stat. 680.

The court below also failed to appreciate that a literal construction of the clause (A) definition could not be supported after the Revenue Act of 1924 introduced the definition in clause (B). Its reliance upon *C. H. Mead Coal Co.* v. *Commissioner, supra,* is shown to have been misplaced by that court's later decision in *G. & K. Mfg. Co.* v. *Commissioner, supra.* We do not contend, as suggested by the court below, that the requirement of control found in clause (B) is to be incorporated in clause (A). That would only accomplish a further overlapping of the statute. Our position is that transactions which partake of the nature of mergers or consolidations may be treated as reorganizations (provided they comply with other requirements) without regard to the stock control requirement of clause (B). In other words, the important question when dealing with the clause (A) definition is

whether the transaction partakes of the nature of a merger or consolidation, while the important element in the clause (B) definition is the "control" requirement.

Moreover, we think that the purpose of Congress to favor business reorganizations is an inadequate basis for extending the scope of the statute beyond its manifest purpose and for disregarding the limits of the Congressional bounty. Upon this point the decision below overlooks the settled rule that provisions of taxing statutes granting immunity from taxation are to be strictly construed against the taxpayer. *Pacific Co.* v. *Johnson*, 285 U. S. 480, 491. While the theory of the reorganization provisions is that the tax will be deferred only, the result is at least a temporary exemption, and for present purposes the rule of strict construction would seem to apply. The statement of the court below, that there is no ground for holding that the continuance of interest must be of essentially the same interests, overlooks the basic purpose of Congress to disregard merely formal changes. That purpose necessarily colors the construction of all of the reorganization sections and must be treated as a gloss on the definition of reorganizations, as well as on the other provisions. The construction of the statute in *John A. Nelson Co.* v. *Commissioner, supra*, is squarely opposed to the liberal view of the court below.

We submit that the construction of the statute adopted by the court below exposes the statute to manipulation and abuse which can be avoided only by an adherence to the broad principles which actuated Congress in enacting the reorganization provisions, and a limitation of their application to transactions which meticulously comply with all of the specific requirements, as well as those which are implicit in the statute.

III

RESPONDENT DID NOT TRANSFER "SUBSTANTIALLY ALL" ITS ASSETS TO THE GRAND UNION COMPANY IF A PRIOR TRANSFER BE TAKEN INTO ACCOUNT

As pointed out by the dissenting opinion below, there is a separate ground for holding that this transaction does not satisfy the statute. Respondent contends that it transferred substantially all of its property to the Grand Union Company, but it is only by disregarding an anticipatory transfer of a portion of its assets to the Peterson Investment Company that there is any basis for this contention.

The record shows that respondent formed, or caused to be formed, the Peterson Investment Company, a corporation, and transferred thereto certain of its assets in exchange for the entire capital stock of the Peterson Investment Company. This transaction was in pursuance of a resolution adopted by the stockholders at their meeting of

June 18, 1928. (R. 26.) The assets so transferred to the newly formed corporation consisted of real estate and buildings, investments, and other miscellaneous assets (R. 11), which were not to be transferred to the Grand Union Company (R. 16). Some of this real estate was later leased to the Grand Union Company by the Peterson Investment Company. (R. 18.) The Board of Tax Appeals found (R. 84) that "Thus reduced, the entire assets of the Minnesota Co. * * * were transferred to the Grand Union Co. * * *." The prior transfer left respondent with only the assets to be transferred to the Grand Union Company, and it was only by this anticipatory transfer that respondent avoided retaining such assets after the transfer to the Grand Union Company, and avoided becoming itself the landlord of the Grand Union Company in place of the Peterson Investment Company.

We submit that on the principles announced in *Gregory* v. *Helvering*, 293 U. S. 465, 470, this statute may not be literally applied to defeat the manifest purpose of Congress. If such anticipatory transfers are countenanced, the attempt of Congress to limit the benefits of this statute to transfers of "substantially all" the assets of a corporation will be set at naught and the astute taxpayer will be permitted to manipulate the statute to his own advantage.

Since these separate transfers are so evidently related, and are parts of a preconceived plan, this

is a case in which they should be treated as parts of a single transaction. The courts have not hesitated to apply the principle that the substance of a transaction must prevail over the form, and, consequently, to keep in view the entire transaction as a complete unit. *Tulsa Tribune Co.* v. *Commissioner*, 58 F. (2d) 937 (C. C. A. 10th); *Prairie Oil & Gas Co.* v. *Motter*, 66 F. (2d) 309 (C. C. A. 10th); *American Security & Trust Co.* v. *Tait*, 5 Fed. Supp. 337 (Md.).

CONCLUSION

In view of the foregoing, we respectfully submit that the decision of the Circuit Court of Appeals should be reversed.

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NOVEMBER, 1935.

APPENDIX A

REVENUE ACT OF 1928, C. 852, 45 STAT. 791

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) *Exchanges solely in kind.*—

* * * * *

(4) *Same—Gain of corporation.*—No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.

* * * * *

(d) *Same—gain of corporation.*—If an exchange would be within the provisions of subsection (b) (4) of this section if it were not for the fact that the property received in exchange consists not only of stock or securities permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then—

(1) If the corporation receiving such other property or money distributes it in pursuance of the plan of reorganization, no gain to the corporation shall be recognized from the exchange, but

(2) If the corporation receiving such other property or money does not distribute it in pursuance of the plan of reorganization, the gain, if any, to the corporation shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property so received, which is not so distributed.

* * * * *

(i) *Definition of reorganization.*—As used in this section and sections 113 and 115—

(1) The term "reorganization" means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), or (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, or (C) a recapitalization, or (D) a mere change in identity, form, or place of organization, however effected.

(2) The term "a party to a reorganization" includes a corporation resulting from a reorganization and includes both corporations in the case of an acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation.

(j) *Definition of control.*—As used in this section the term "control" means the ownership of at least 80 per centum of the voting stock and at least

80 per centum of the total number of shares of all other classes of stock of the corporation.

TREASURY REGULATIONS 74 (PROMULGATED UNDER THE REVENUE ACT OF 1928)

ART. 577. *Definitions.*—The term "reorganization," as used in sections 112, 113, and 115 means—

(1) A merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation),

(2) A transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred,

(3) A recapitalization, or

(4) A mere change in identity, form, or place of organization, however effected.

The term "a party to a reorganization" as used in sections 112 and 113 includes a corporation resulting from a reorganization and includes both corporations in the case of an acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation. This definition is not an all-inclusive one, but simply enumerates certain cases with respect to which doubt might arise.

A person is, or two or more persons are, "in control" of a corporation, within the meaning of section 112, when owning—

(1) At least 80 percent of the voting stock, and

(2) At least 80 per cent of the total number of shares of all other classes of stock of the corporation.

As used in section 112, as well as in other provisions of the Act, the conjunction "or" is used to denote both the conjunctive and the disjunctive, and the singular is used to include the plural. For example, the provisions of article 574 are complied with if "stock and securities" are received in exchange as well as if "stock or securities" are received, and if securities in the same corporation, together with securities in another corporation a party to the reorganization or in other corporations parties to the reorganization, are received in exchange.

APPENDIX B

House Committee Print, 73d Congress, 2d Session, Preliminary Report of a Subcommittee of the Committee on Ways and Means, Submitted December 4, 1933, on "Prevention of Tax Avoidance", pp. 8–9, 37–39, 42:

(5) *Exchanges and Reorganizations*

Your subcommittee makes the following recommendations with respect to exchanges and reorganizations:

(a) That the exchange and reorganization provisions contained in section 112 of existing law be abolished;

(b) That in cases where the immediate payment of the tax on a gain resulting from an exchange or reorganization results in undue hardship to the taxpayer, the Treasury be granted authority to extend the time for the payment of that portion of the tax attributable to such gain for a period not in excess of 2 years.

The elimination of the exchange and reorganization provisions will serve a twofold purpose. First, it will close the door to one of the most prevalent methods of tax avoidance. Second, it will greatly simplify the income tax law by eliminating some of its most complicated provisions. The underlying principle behind all of the exchange and reorganization provisions of the present law is that they do not result in tax exemption, but that the tax is postponed. It is

claimed that many of the so-called exchanges or reorganizations result in mere paper profit, and that to tax them at the time of the exchange will seriously interfere with business. However, under the existing system the taxpayer is able to escape tax on these gains entirely by being permitted to elect the year in which he shall report such gain.

Many of the exchanges and reorganizations which the Supreme Court holds result in taxable income under the Revenue Act of 1917 and prior acts are now made tax-free under the present law. Your subcommittee is of the opinion that any system is unsound which does not tax gains in the year in which realized. The year of realization is the year in which such gains become income under the Constitution, and to defer the taxing of gains until later years opens a wide field of tax avoidance.

For these and other reasons stated in the report of the staff of the joint committee contained in exhibit D of the appendix, your subcommittee is of the opinion that the exchange and reorganization provisions of the present law should not be retained. It is estimated that this change will result in a saving to the Government of at least $18,000,000 annually.

* * * * *

APPENDIX

* * * * *

EXHIBIT D

MEMORANDUM ON EXCHANGES AND REORGANIZATIONS

Under the Revenue Acts of 1913, 1916, and 1917, Congress taxed all gains from

transactions involving exchanges or reorganizations in the year in which such gains were realized. The Supreme Court in a number of cases arising under those acts held that gain was realized in fact in the year in which the exchange or reorganization took place. This was true, although the taxpayer did not receive actual cash but stock or securities, which the court regarded as the equivalent of cash. However, serious opposition to taxing gains of this character developed. It was claimed that such gains were mere "paper profits", i. e., the taxpayer had realized nothing tangible and to tax them seriously interfered with normal business adjustments.

The Revenue Act of 1918 continued the policy adopted in the prior income tax laws of taxing gains when realized, with the one exception of an exchange of stock for stock (in connection with the reorganization, merger, or consolidation of a corporation) when the stock or securities received had no greater aggregate par or face value than the stock exchanged. The history of the act discloses that the House defeated a Senate amendment designed to extend this privilege to other types of transactions.

The first serious change in this policy occurred in the Revenue Act of 1921. That act exempted from immediate tax exchanges of investment and business property for property of like kind and exchanges of stock or securities in connection with corporate reorganizations. It was soon found that these provisions left the door wide open for various devices to avoid tax. Most important of these devices was one whereby property could be transferred to a corporation and its cost to the corporation determined

by the fair market value of the property at the time of the transfer. The corporation would then use such enhanced value in computing its gain from a subsequent sale. Moreover, the exchange provisions permitted a tax-free exchange of stock or securities not connected with a reorganization. Many brokers, investment houses, and bond houses established exchange departments and advertised to their customers that they could exchange securities in such a manner as to result in no taxable gain. The situation became so serious that Congress in 1923 was forced to pass a special act removing the exemption in the case of stock or securities exchanged otherwise than through a corporate reorganization.

The Revenue Act of 1924 is the nucleus about which the present provisions were built. While the later acts have made certain changes in these provisions, such changes were designed to plug up some of the more obvious loopholes without attempting to make any change in principle. All of the reorganizations which the Supreme Court held to result in taxable income under the Revenue Act of 1917 and prior acts are now made tax free under the present law.

The exchange and reorganization provisions of the present law will now be briefly discussed. Under section 112 of the Revenue Act of 1932, gain or loss is recognized upon the sale or exchange of property with certain specified exceptions. These exceptions provide that no gain or loss shall be realized in the following cases:

(1) If investment property or property used in a trade or business is exchanged for property of a like kind. This rule does not apply to stock in trade, property held primarily for sale, or stocks or bonds.

(2) If common stock in a corporation is exchanged solely for common stock in the same corporation;

(3) If preferred stock in a corporation is exchanged solely for preferred stock in the same corporation;

(4) If stock or securities are exchanged solely for other stock or securities in a corporate reorganization;

(5) If property is exchanged by a corporation for stock or securities in another corporation pursuant to a corporate reorganization;

(6) If property is transferred to a corporation by one or more persons and immediately after the transfer such person or persons are in control of the corporation.

Furthermore, if stock or securities are distributed to a shareholder upon reorganization of a corporation without surrender of his stock or securities, no gain is recognized to the shareholder from such receipt. Moreover, if in any of the above transactions the taxpayer receives money or other property in addition to the property specified and there is in fact a gain from the exchange or reorganization, such gain is recognized at that time to the extent of the other property or money received. However, this last rule does not apply to a corporation if the corporation distributes such money or other property to its stockholders.

In support of the theory that the above provisions do not result in tax exemption but merely in tax postponement, the law contains other provisions designed to prevent the taxpayer from stepping up his original cost when he sells the property received in exchange for the old property. The general theory is that the property received in ex-

change takes the place of the old property. In the case of property transferred to a corporation, the law also requires the corporation to use as its basis the cost of the property to the transferor, if after the transfer such transferor controls a majority interest in the corporation.

The underlying principle behind all of the exchange and reorganization provisions of the present law is that they do not result in tax exemption, but that the tax is postponed until a gain is realized from a pure sale or what amounts to a pure sale. The reasons assigned for such a policy are—

(1) That such provisions prevent much of the uncertainty and litigation which was involved in the prior income-tax laws;

(2) Normal business adjustments will not be interfered with if so-called "paper profits" are exempted;

(3) The revenues of the Government will be increased by preventing taxpayers from taking colorable losses.

The Bureau has now had an experience of more than a decade in the administration of these provisions. This experience shows that the abuses under the present policy far outweigh the advantages. In the first place, the provisions of the present law are very involved, difficult to understand, and particularly hard to interpret in the light of actual cases as they arise. The interpretation placed upon these provisions by the Treasury has been overturned by the courts in many cases, so that at present there is a great deal of confusion and uncertainty.

In the second place, the administrative problems in ascertaining the value of property made necessary under the prior acts have not been greatly reduced by the pro-

visions of the law, for where money or other property is received in addition to stock or securities, it is necessary to value the stock or securities in order to determine whether an actual gain has been realized. In many corporate reorganizations, while cash is not involved, the acquiring corporation generally assumes some of the indebtedness of the old corporation, which indebtedness is regarded as the equivalent of cash.

The second reason assigned for the change in policy appears to have been based upon the complaint that taxing the gain when realized seriously interfered with normal business readjustments. The very high tax rates of the 1917 and 1918 acts, it was claimed, imposed upon the taxpayer the burden of having available substantial cash at a time when the transaction resulted in a mere "paper profit." While this claim undoubtedly has some merit, it is believed that the present provisions have been utilized for other purposes of an indefensible character. Many reorganizations have been undertaken for the purpose of avoiding taxes. Furthermore, the present provisions have encouraged the injection into business structure of an unsavory stimulus, such as the organization of large holding companies and the overcapitalization of business.

The third reason assigned was that these provisions would prevent the taking of heavy losses, thereby resulting in an increase in the revenues of the Government. While these provisions may have rendered it more difficult for taxpayers to take losses, it by no means closed the door. The taxpayer upon "legal advice" prior to the arrangement of the terms of the transaction may still take substantial losses in most instances without

actual interference with his original plan and purpose.

The statute provides that upon the sale or exchange of property the entire amount of gain or loss shall be recognized, with certain exceptions. The exceptions are the exchange and reorganization provisions already referred to. If a taxpayer desires to take a loss, it is easy to arrange a transaction falling without the exceptions. On the other hand, if it is desired to pay no tax on the gain, the transaction can be so arranged as to come within the exceptions. In addition, losses from the sale or exchange of stocks and bonds are limited, to a large extent, to the gains from such sales or exchanges, so in many cases a stock or bond loss even if recognized could not be utilized by the taxpayer.

Instead of increasing the Government revenues, these provisions appear to result in a considerable loss of revenue. The theory of postponing the gain by shifting the original cost basis of the transferor over to the transferee or by requiring the transferor to keep his original cost basis for the property he receives in exchange does not compensate the Government for exempting the prior transaction from tax. This is due to the fact that in the year which the taxpayer chooses to realize the gain he may have heavy losses, or the tax rates may be different. Death and other elements may also enter in to create a new cost basis for the property.

One of the main objections to the reorganization provisions is that the recognition of gain depends more upon the form of the transaction than upon the essential facts, undue importance being given to "expert

advice." Therefore, in practice, the sections sometimes result in double taxes and sometimes in complete tax exemption. In many cases the shifting of the cost basis of property over to a transferee corporation frequently causes the tax burden to fall upon the backs of new stockholders, who have paid full market value for their stock.

* * * * *

In view of the matter already presented, the following suggestions are made:

(1) To abolish the exchange and reorganization provisions of the present law.

(2) To eliminate all of the exchange and reorganization provisions of the present law, except those permitting an individual to incorporate his business without being subject to tax.

(3) To require gain to be realized and the tax determined at the time of the exchange or reorganization under plan (1) or plan (2), but not to enforce payment of the tax for a period (A) within 2 years from the date the tax is due, or (B) within 6 months after the property is received is sold, whichever date is the earlier. Under this plan, the Government should be protected by the giving of the proper bond and the suspension of the statute of limitations during this period. In any case where cash is received at the time of the exchange, it is believed that the tax should be paid immediately up to the extent of the cash received.

Under all of the above plans, provision should be made for continuing the basis provisions of existing law with respect to property acquired pursuant to an exchange or reorganization consummated prior to the enactment of the proposed act. This will prevent a taxpayer who has acquired prop-

erty in a tax-free exchange or reorganization from avoiding tax by getting a stepped-up basis.

This memorandum has been prepared by Mr. Colin F. Stam, counsel, and Mr. G. D. Chesteen, corporation auditor, of the staff of the Joint Committee on Internal Revenue Taxation. It meets with the approval of the undersigned.

Respectfully submitted.

L. H. PARKER, *Chief of Staff.*

Statement of the Acting Secretary of the Treasury Regarding the Preliminary Report of a Subcommittee of the Committee on Ways and Means on "Prevention of Tax Avoidance", pp. 9–10:

(5) *Exchanges and reorganizations.*—Early decisions of the Supreme Court indicated that in the absence of any specific statutory provisions an exchange of one piece of property for another piece of property might result in taxable gain or deductible loss, as the case may be. In other words, if a farmer traded one horse for another horse, even without any boot, gain or loss should be computed for income tax purposes. The court did not limit the realization of gain or loss to cases in which the property had a readily realizable market value.

Although these decisions were theoretically justified, Congress came to the conclusion 12 years ago it was not practicable to administer the income tax on this basis. There are doubtless thousands of horse trades and similar barter transactions every year. To attempt to evaluate the property received in exchange in each case would be an enormous administrative task which, particularly in these years, would be very unlikely to show any considerable net revenue.

Consequently, Congress in substance provided that gain or loss would be recognized on exchanges of property having a readily realizable market value, such as stocks, bonds, and negotiable instruments; on exchanges of property held primarily for sale; or on exchanges of one kind of property for another kind of property; but *not* on exchanges of property solely for property of a like kind. This provision has been in effect for 12 years.

The experience of the Treasury is that the provision does not result in tax avoidance or loss of revenue, but rather represents a fair and practical solution of the problem. It will be noted that the exempt exchanges are strictly limited to transactions in which it would be administratively difficult to determine any gain or loss. In the opinion of the Department the abolition of the exchange provisions would not result in increased revenue, while at the same time additional expense in administration would be caused. The Department therefore recommends that no change be made in the exchange provisions.

The reorganization provisions are, as the subcommittee states, perhaps the most complicated and difficult to understand of any sections of the law. In addition to their complexity, they are open to the serious objection of being over specific. When they were adopted in 1924, the draftsmen attempted to state in minute detail exactly how each step of a reorganization should be treated for tax purposes. Although this method had the apparent advantage of enabling taxpayers and their lawyers to determine in advance exactly how proposed transactions would be taxed, it had the dis-

advantage of leaving the Department no leeway in the administration of the law. Consequently, astute lawyers could and did arrange what were really sales to take the technical form of a reorganization within the statutory definition, with resultant loss of revenue. The Treasury has fought a number of these cases through the courts, with results on the whole favorable. The courts have attempted to work out the general principles underlying the statute, and to interpret the specific sections in such a way as to carry out the general plan and to prevent avoidance.

In the light of this experience of 10 years, the Treasury has come to the conclusion that the present provisions should be completely redrafted. The purpose should be to express in the statute as simply as possible the general plan for dealing with these transactions, leaving to the Department as in other cases the power to make rules and regulations to carry out the congressional intent. Congress has previously dealt with the subject of affiliated corporations in this way, with excellent results so far. In the cases of complicated subjects of this kind, it is almost impossible to foresee all the ingenious devices which lawyers will invent, and to provide against them expressly in the statute. The more effective plan is to place the responsibility squarely upon the Department administering the law from day to day. It can readily amend its regulations to cover new situations as they arise.

The question then is whether the present provisions should be scrapped in their entirety before a satisfactory substitute can be framed. The committee should carefully consider several problems before this is

done. In the first place, depreciation and depletion are now calculated for thousands of corporations on the basis of costs figured under the present reorganization provisions. These sections in general required the new corporation to take the same cost as the old for depreciation and depletion purposes, even though the assets had greatly increased in value. If the provisions were abolished outright, many of these taxpayers could and would claim largely increased amounts of depreciation and depletion, with resultant loss of revenue. In the second place, reorganizations today are generally being carried out in order to revise the capital structures of unsuccessful or insolvent enterprises. The immediate result of abolishing the reorganization provisions would be to permit the thousands of bondholders and stockholders of such organizations to establish losses, even though they obtain and retain securities in a new enterprise which is substantially the same as their original investment. Even though it be required that such losses can only be deducted from capital gains, a wide door will be opened to reduction of tax liability. Finally, there are many legitimate reorganizations in which the present general policy of the law is sound; where, as a result of a merger, for example, a stockholder receives 10 shares in a new Illinois corporation in place of 10 shares in the former Ohio corporation. The ordinary shareholder in this situation will find it hard to see why an income tax should be imposed until he sells the new shares.

For these reasons, the Treasury believes that it would be unwise to eliminate completely the exchange and reorganization provisions at this time. The Department is now

working upon a substitute for the present provisions, which will be completed as soon as possible. The task is not easy, on account of the complexity of the transactions involved. Until the various alternatives can be carefully studied, and a plan worked out which will work fairly and safeguard the revenues, it does not appear advisable to abolish completely the present statutory plan. The Department believes, as stated, that the proposal would not only yield no additional revenue, but would result in a net loss.

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